ACTIVELY MANAGED ETFS: THE NEXT GENERATION?

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Actively managed exchange-traded funds have been stuck on the starting block for years now. The idea has been talked up and talked back down by so many Wall Street practitioners and academics that it seems remarkable someone hasn't gone ahead and launched one in the U.S. Every other ETF permutation seems to have been tried.

First introduced by State Street in 1993, ETFs have exploded in popularity in recent years. Total industry assets closed 2006 at $422.5 billion, up from $71 billion in 2000. In the formative years, ETFs simply replicated large, cap-weighted indexes such as the S&P 500 or Russell 1000. But as they proliferated, the trend evolved from simple wide-swath index-tracking to thinly sliced sector carve-outs and proprietary stock, commodity and debt groupings.

Fundamentally weighted ETFs — equally weighted portfolios based on fundamentals, such as earnings, dividends, revenue and book value — changed the paradigm. Research conducted by Robert Arnott of Research Affiliates and Jeremy Siegel of the Wharton School and WisdomTree Investments showed that such weightings provided superior risk-adjusted returns.

I. The Next Step

Some argue that fundamentally weighted ETFs are really actively managed, or at least semi-actively managed. So why not go active all the way? The notion has been circulating for years, but there are some good reasons why there aren't a slew of actively managed ETFs.

To maintain efficient NAV pricing, transparency is a must. Authorized participants need to know the portfolio's components in order to make in-kind redemptions and creations (redemption/creation is the lingo used to describe the process of delivering a specified basket of securities to the fund in exchange for ETF shares and vice versa). Without full disclosure, it is impossible to deliver an accurate basket of the underlying shares. What's more, the Securities and Exchange Commission stipulates that ETFs must disclose their holdings daily, and active managers are loathe to reveal their holdings for fear of being front-run by the market.

So the question becomes, how much disclosure is enough? “You can't have total transparency,” says Scott Gibson, finance professor at the College of William & Mary. “The sticking point is how often the ETFs need to give a snapshot of their holdings.” Gibson suggests a structure where only a few market makers possess up-to-the-minute holding information. This would allow the ETF manager enough time to execute his stock picks while ensuring efficient pricing for investors.

According to Cliff Weber, senior vice president of the American Stock Exchange's ETF marketplace, another solution — one endorsed by the AMEX — would be for actively traded ETFs to disclose their holdings generically, using a proxy or tracking portfolio. This tracking portfolio would mimic the intraday movement of the fund, but wouldn't permit reverse engineering of the fund's holdings.

“We have applied for a couple of patents that would allow for the creation of a second portfolio that is similar to the stocks the manager has actually picked,” explains Weber.

Gary Gastineau, managing director of ETF Consultants and a leader in the actively managed ETF movement, proposes a different solution: Disseminate precise portfolio values less frequently than indexed ETFs do to keep arbitrageurs from using every-15-second values to decipher exact holdings. "We would have creation and redemption baskets that consist of only settled or reported holdings of the fund," he says. "We would also publish supplementary hedging information for market makers describing the risk characteristics of the rest of the portfolio without revealing its exact contents." Weber believes a solution could be implemented by year's end, but he admits it won't be a universal solution.

II. If They Build Them, Will They Come?

There are many reasons to index, the most obvious: Most active money managers fail to consistently beat their passive, cap-weighted benchmarks, such as the S&P 500. Despite this fact, about 80 percent of equity mutual fund assets remain with active managers, according to the ICI. Why? Hope springs eternal and, apparently, most investors would rather "go for it" than go with an index and surrender the possibility of superior returns.

Are the majority of investors on a fool's errand? Even if a fund manager is great, the game is stacked against him; trading costs dampen returns and so do the manager's liquidity needs. Mutual funds must meet redemptions, so managers have to hold cash — sometimes in the mid to high-single digits.

If only there were a better investing vehicle, maybe active money managers could beat the market more consistently. In fact, that appears to be the case. According to an academic paper co-authored by Gibson, when mutual fund managers buy stocks because they have promising information about them, those stocks outperform their benchmarks by almost by 3 percent annually. But when they buy for liquidity reasons — to redeem departing shareholders — performance lags.

"The free flow of liquidity is costly," says Gibson. "The fund structure forces these liquidity trades. If you can free up the manager from making these trades, he can create value."

If the mutual fund structure is to blame for the high failure rates of active money managers, then change the structure and you get rid of the problem. ETFs charge lower fees because investors don't interact directly with the fund; shares are traded on an exchange. The ETF structure also insulates the fund from daily cash flows and allows the fund to accept holdings (and deliver them) without incurring transaction costs. The result: Managers can streamline staff, avoid cash drag and simplify back-office functions.

Of course, critics counter that gains won as a result of ETF structure will be offset in an actively managed vehicle by a loss of tax efficiency, one of the primary advantages of ETFs and indexed investing. But Herbert Blank, president of QED International Associates, believes that argument is overstated: "Active ETFs are unlikely to distribute zero capital gains as frequently as indexed ETFs, but they're likely to distribute far less than they would under the active mutual fund structure."

III. The Future Is Now… In Europe

Deutsche Bank's DWS Investments has sponsored actively managed ETFs, listed on German exchanges, for the past seven years. The Deutsche Bourse of Frankfurt has addressed the

disclosure issue by allowing DWS to disclose its holdings to institutional shareholders every day with a two-day delay and to the general public after it's a month old. The SEC declined to comment on the matter, but would probably frown on such an arrangement.

Domestically, Deutsche Bank's **Strategic Value Index Fund** (FDV) is the closest incarnation of an actively managed ETF. Its First Trust Portfolios tracks 40 stocks selected from the S&P 500 based on price-to-earnings ratios to create a basket of value stocks. What makes this ETF unique is that the index it follows readjusts its 40 component stocks monthly.

So far, results are encouraging: The Strategic Value Index Fund sports a 0.65 percent expense ratio, yet has returned 11.75 percent since its inception in September 2006, while the SPDR (SPY), the well-known S&P 500-tracking ETF, has an expense ratio of 0.10 percent, but has returned only 9.34 percent over the same period.

Blank believes the first true actively managed equity ETF in the U.S. is just beyond the horizon, and its first incarnation will likely be based on a large, cap-weighted index, where a core index will serve as both the fund's benchmark and its initial construction basis. "The index holdings and weights would be submitted to an optimizer," he explains. "The result will be a portfolio with risk characteristics similar to a benchmark, but tilted to give greatest emphasis to stocks most preferred by the manager."

But it might be a short-term debt offering that finally brings actively managed ETFs into the mainstream. **Bear Stearns recently registered its Bear Stearns Current Yield Fund**, which will use active strategies in an attempt to deliver superior yields to the average money-market account. The fund sidesteps the creation and redemption problem by allowing both to occur in cash. Because the fund holds "cash-like" instruments bought from a liquid market, it matters little to the portfolio manager if he receives cash.

"The key to getting these things going is to get a well-capitalized organization to make the first move," says Bill Seale, CIO of ProFunds. "The thing is to get it right first. Once that happens, I think you could see the floodgates open."